Supreme Court of the United States

OCTOBER TERM, 1940.

LONG ISLAND DRUG COMPANY, INC.,
Petitioner,

against

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

Statement of the Case.

This is a petition for a writ of certiorari to review a decision of the United States Circuit Court of Appeals for the Second Circuit, which affirmed orders of the Board of Tax Appeals determining deficiencies in Petitioner's income taxes for the years 1931, 1932 and 1933.

Official Reports of Opinions Below.

The case in the Board of Tax Appeals is reported as *Long Island Drug Co.* v. *Commissioner of Internal Revenue*, 35 B. T. A. 328.

In the Circuit Court of Appeals it is reported as *Long Island Drug Co.* v. *Commissioner of Internal Revenue*, 111 Fed. (2d) 593.

Grounds on Which Jurisdiction Is Invoked.

Jurisdiction is invoked on the grounds that the United States Circuit Court of Appeals for the Second Circuit erred in deciding important questions of general law, apparently in conflict with the decisions of other Circuit Courts of Appeals; questions not yet determined by the Supreme Court.

Material Facts.

Petitioner, Long Island Drug Company, Inc., was incorporated in 1917 (R. 28, 51) with an authorized capital of $10,000, but it began business with a paid in capital of but $3,000 (R. 51, 56). For this capital it issued thirty shares, ten each to Mr. Hyman Alkon, Mr. Maurice Alkon and Mr. Bernard H. Mindling, who were also its officers (R. 51, 52, 60, 62). Its business was the wholesale drug business. It entered into competition with old, well-established concerns (R. 56).

Within four years its net worth had apparently grown from the original $3,000 to $78,000, because in 1921 its three shareholders each sold one-half of his holdings for a total of $39,000 (R. 28, 52, 80). The shares so sold were taken in the name of Mr. Benedict Maisel, a nominee for the beneficial owners, the parents of Mr. Charles J. Steinberg (R. 28, 64, 80, 84).

By the beginning of 1931 the company had so prospered that in addition to its original capital of $3,000 it had a capital surplus of $390,753.22 (R. 56).

There was dissension among the stockholders. The three original shareholders, who were still the executive officers, were dissatisfied with the salaries they were getting. Mr. Steinberg wanted the business of the corporation enlarged—he wanted it to go into Brooklyn, which it had not covered theretofore—and he wanted it to enlarge further by developing a line of merchandise under its own trade name. This the old officers were unwilling to do. They took the position that they had enough work to do as it was (R. 58). This

disagreement led to a proceeding in the New York Courts praying for dissolution of the corporation. The petition was dismissed, but out of the proceeding grew a compromise. By this compromise the new territory was opened and the new line of merchandise offered (as the Steinberg interests had wished) and Mr. Steinberg himself was employed to do this additional work, among other things (R. 29, 58-59, 84). The compromise also included an arrangement about salaries—the arrangement under which the salaries under examination were paid.

This arrangement was embodied in a by-law of the corporation adopted March 11, 1931, which read:

> "Section 6. Compensation of Officers. The President shall receive a salary of $13,500 per annum, the Treasurer shall receive a salary of $12,500 per annum, the Secretary shall receive a salary of $12,500 per annum, and the Assistant Secretary shall receive a salary of $12,500 per annum. In addition thereto each of said officers shall receive as additional compensation an amount equal to 12½% of the net profits of the corporation. The foregoing compensations shall continue in force undiminished unless changed by unanimous consent of the Board of Directors. Net profits of the corporation for purposes of this section shall be determined by subtracting from the net profit returned to the Federal Government the amount of State and Federal taxes paid or due thereon" (Ex. 4; R. 113).

Pursuant to this by-law the salaries in question were paid. They were (30):

1931.

	Fixed	*Contingent*	*Total*
H. Alkon, President.....	$13,500	$ 8,000	$21,500
M. Alkon, Treasurer.....	12,500	8,000	20,500
B. H. Mindling, Secretary.	12,500	8,000	20,500
C. J. Steinberg, Assistant Secretary.....	12,500	8,000	20,500
Total.....	$51,000	$32,000	$83,000

1932 AND 1933.

	Fixed	*Contingent*	*Total*
H. Alkon, President.....	$13,500	$ 2,500	$16,000
M. Alkon, Treasurer.....	12,500	2,500	15,000
B. H. Mindling, Secretary.	12,500	2,500	15,000
C. J. Steinberg, Assistant Secretary.....	12,500	2,500	15,000
Total.....	$51,000	$10,000	$61,000

It will be noted that the percentages of income paid these executives for salaries bore no relationship to stockholdings. Mr. Steinberg, whose parents owned 50% of the stock, received but 12½% of the profits. The old officers, who divided the other half of the stock among themselves, received 37½% of the profits.

Petitioner deducted the taxes so paid in its income tax returns. When the 1931 return was audited the Commissioner deducted so much of the salaries as were based upon percentages of net income, saying:

> "The 'extra distribution' of $32,000 was not the result of free bargaining which clearly indicates that the payments were not compensation for the value of services rendered, but represent a distribution of profits, and are therefore, not ordinary and necessary expenses within the meaning of section 23 (a) of the Revenue Act of 1928 (Botany Worsted Mills v. United States, Cumulative Bulletin VIII-I, p. 271; Samuel Heath Company v. United States, 2 Fed. Supp. 637)" (R. 11).

A year later the returns for 1932 and 1933 were under examination, and the Commissioner, without making any fresh examination of the question, again disallowed the contingent (percentage of profit) salaries, writing:

> "The amount of officers' and attorneys' salaries allowed as a deduction is based upon a decision at a conference in the office of the internal revenue agent in charge with respect to the year 1931" (R. 22).

The taxpayer filed petitions with the Board of Tax Appeals. The petitions were heard together. Petitions for review were filed with the United States Circuit Court of Appeals for the Second Circuit. The Board was there affirmed.

Summary of Argument.

The case presents two questions of general importance:

(a) Is the presumption that the Commissioner of Internal Revenue acts correctly a mere procedural presumption, or is it a presumption of substance which may be weighed against uncontradicted proof offered by the taxpayer?

The Circuit Courts of Appeals for the Third and Sixth Circuits have held the presumption to be only procedural.

(b) Is not proof that the salaries of the executives of a corporation have been arrived at in due course *prima facie* proof that they are reasonable, requiring some proof to overcome it?

The Circuit Court of Appeals for the Fourth Circuit has so held. The decision of the Circuit Court of Appeals below cannot be reconciled with these decisions of the Third, Fourth and Sixth Circuits.

POINT I

The presumption that the Commissioner is correct is purely procedural, and the Third and Sixth Circuits have so held.

The question of fact before the Board was whether the salaries were reasonable. It made findings of other facts, evidentiary facts in considerable detail (R. 27-32). It made *no* finding of fact as to the essential point in dispute. The

learned Assistant Attorney General who wrote respondent's brief below concurred with us in this, because he wrote:

> "The Board made no findings as to whether the payment of 12½% of the net earnings of the corporation to each of the four executive officers, a total of 50% of the net earnings, was reasonable compensation for services rendered and explained its failure to do so in its opinion * * *" (p. 12, brief below).

Nevertheless, the Circuit Court of Appeals, endeavoring to sustain the Board, said:

> "The petitioner says that the Board made no finding that the compensation paid was unreasonably high. It is true that the Board made no such finding in specific terms. What the Board did do was to hold that the burden was on the petitioner to show that the amounts paid were no more than reasonable, the petitioner's evidence was too weak to carry the burden. We regard this as the equivalent of a specific finding by the Board that the compensation paid, over and above the amount allowed by the commissioner as deductible, was unreasonably high" (R. 129).

But this interpretation disregards what the Board said. It is wrong to assume that the Board used language inadvertently. What the Board said was that petitioner's proof failed

> "to sustain the *burden* of proof *to show* that *respondent's determination* was erroneous" (our italics, R. 35).

It did *not* say that Petitioner's proof (the only proof) showed or even suggested unreasonableness. So it was not inadvertent that the Board made *no* specific finding as to the one ultimate fact before it. It was deliberate. It was because the Board conceived that the presumption that the Collector was right is one of *substance,* of some *great weight,* so that *no fact* is presented to the Board for decision until the petitioner presents proof of whatever arbitrary weight standard the Board has adopted.

Decisions of Other Circuits.

The Third Circuit has held:

> "* * * the presumption that the determination of the Commissioner is right is simply procedural and cannot survive the production of evidence tending to show the determining fact * * *" (*Manchester Board & Paper Co., Inc.* v. *Commissioner of Internal Revenue,* 89 Fed. [2d] 315, 317).

The Sixth Circuit has held:

> "The presumption that the Commissioner is right is procedural * * *" (*Lunsford* v. *Commissioner of Internal Revenue,* 62 Fed. [2d] 740, 742).

Decision of This Circuit.

The Circuit Court of Appeals below did not *expressly* disagree with these decisions. What it wrote was:

> "The Board was right in holding that the burden of proving that the claimed deduction was proper was on the petitioner. *Burnet* v. *Houston,* 283 Fed. 223. The burden was not merely one of going forward with evidence, as the petitioner maintains" (R. 129).

Petitioner never contended before that court that the taxpayer does not have both the burden of proceeding with proof and the burden of preponderating, once *conflicting* proof has raised an *issue.* What Petitioner contended was (a) the presumption that the Collector is right is purely procedural; (b) Petitioner's proof that the salaries were arrived at in regular course is *prima facie* proof that they were reasonable unless something inherent in the facts suggests the contrary (which the Circuit Court of Appeals did not intimate), and, therefore, since there was no *conflicting* proof, there was *no* evidence on which to base a finding of unreasonableness. In the light of this argument the Court evidently rejected the decisions in the Third and Sixth Circuits holding that the presumption is only procedural. That was the *only* contention of Petitioner, and Petitioner's contention, the Circuit Court of Appeals said, was wrong.

POINT II

Proof that the salaries of business executives were fixed in due course creates a presumption that they are reasonable, requiring some proof to overcome it.

We concede that such contradictory proof may be inherent in the facts themselves, but the Circuit Court of Appeals did not pretend to find such proof here. It wrote:

> "It may fairly be said in the petitioner's favor that the case is not one where utterly extravagant amounts were paid to officers, in guise of compensation but without real relation to the measure of their services. *Botany Mills* v. *United States,* 278 U. S. 282. Nor is it a case where the payments bore a close relation to the stockholdings of the recipients and so might fairly be viewed as dividends for purpose of tax, despite the name given to the payments." (R. 128).

The Circuit Court of Appeals below necessarily rejected Petitioner's argument that when it is shown that salaries are fixed in due course the presumption is that they are reasonable, because it would not have affirmed otherwise. The Commissioner offered no proof. There was no inherent defect in Petitioner's proof—at least none was suggested. Therefore the proof was all one way, if it should be presumed that salaries arrived at in due course are reasonable.

Other Circuit Courts of Appeals have held that there is such a presumption, requiring proof to overcome it.

Circuit Court of Appeals for the Third Circuit.

> "* * * Whether services were rendered, and whether also they were commensurate with the salary paid, are matters of judgment and discretion, reposed by general law in the board of directors of the corporation. As the board of directors is charged with the duty and clothed with the discretion of fixing the

> salaries of the corporation's officers, the government has no right (until expressly granted by statute) to inquire into and determine whether the amounts thereof are proper, that is, whether they are too much or too little. But, while the amount of salary fixed by a board of directors is presumptively valid, it is not conclusively so, because the government may inquire whether the amount paid is salary or something else'" (*United States* v. *Philadelphia Knitting Mills*, 273 Fed. 657).

Circuit Court of Appeals for the Fourth Circuit.

> "The *prima facie* presumption in favor of the action which a corporation has taken in cases of this kind has repeatedly been recognized by the Board of Tax Appeals itself. For example, see Collins-McCarthy Land Co. v. Commissioner, 43 BTA 1280; Standard Silk Dyeing Co. v. Commissioner, 9 BTA 648. This presumption is in nowise inconsistent with the principle that the burden of proof rests upon the taxpayer" (*Ox Fibre Brush Co.* v. *Blair*, 32 Fed. [2d] 42, 45).

Here is a case where the good faith of the corporation has not been questioned. If the fact that salaries of executives were fixed by those managing a business carries no presumption of reasonableness, what remedy does the taxpayer have? There is no *standard* for *executives*. Two businesses, two organizations are seldom precisely alike. Can an examiner of the Bureau of Internal Revenue, at his mere caprice, overrule the judgment of the experienced managers of a business as to what is reasonable? Apparently he can—unless *he* has the burden of producing *some* proof to justify his decision when the taxpayer shows that the salaries were arrived at in regular course, and the surrounding circumstances create no suspicion of irregularity or unreasonableness. The Circuit Court of Appeals concluded:

> "And whatever might have been our views if we had tried the facts, we cannot say that the Board's finding was so clearly out of line with the evidence as to be arbitrary and unfair." (R. 129).

Now, unless such proof *does* require the Collector to come forward with some evidence to justify him, it means that unless the taxpayer proves reasonableness to a practical mathematical certainty (and there can never be such proof on *this* question) it is never "arbitrary" and "unfair" to disregard all the proof entirely—as was done here.

POINT III

Why the decision below is in irreconcilable conflict with the decisions of the other circuits.

We have shown that the Third and Sixth Circuits have held that the presumption that the Collector is right is purely procedural, and the Third and Fourth Circuits have held that proof that salaries were arrived at in regular course is *prima facie* proof of their reasonableness. Although the opinion of the Court below does not mention these decisions (although all were called to its attention) it necessarily rejected some, if not all of them. Because if the Court had been of opinion that Petitioner's proof removed the procedural presumption that the Commissioner is correct; if it had been of opinion that proof of regular course of business is *prima facie* proof of reasonableness (at least in the absence of inherent suspicious circumstances, of which it found none, *supra,* p. 14), then it would have been compelled to decide that there was *no* issue of fact, because respondent had offered nothing to create it.

Thus there is conflict among the circuits as to the character of proof required to sustain the taxpayer's contention, conflict in a matter which has constantly arisen and will continue to arise in the Board of Tax Appeals and which ought to be settled by decision of this Court.

Dated, August 19, 1940.

Respectfully submitted,

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